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Augsburg, 23/10/2006

**Re: ED of Proposed Amendments to IAS 32 *Financial Instruments: Presentation* and IAS 1 *Presentation of Financial Statements: Financial Instruments Puttable at Fair Value and Obligations Arising on Liquidation***

Dear Sir David,

We are pleased to comment on the Exposure Draft (ED) of Proposed Amendments to IAS 32 *Financial Instruments: Presentation* and IAS 1 *Presentation of Financial Statements: Financial Instruments Puttable at Fair Value and Obligations Arising on Liquidation*.

First of all we would like to point out that we appreciate the IASB's constant efforts to improve the quality of the standards. Therefore, we also agree that the current understanding of equity and liability distinction according to IAS 32 needs to be revised in order to comply with the goal of providing high quality, understandable and enforceable global accounting standards.

However, in this particular case we have some reservations about the amendments being proposed. We came to the conclusion that there are several considerations (which will be explained in more detail as replies to your formulated questions) that are not aligned with the overall objectives of the IFRS; therefore, we do not support the ED in its current version but suggest to clarify and even rethink some aspects.

Before we respond to the questions stated in the amendment, we would like to express a more general concern. As stated in par. 5 of the exposure draft, the amendment is to provide a limited scope, short term improvement of financial reporting regarding certain financial instruments.

Our first concern would be the introduction of these kinds of changes in the standards. We feel that a limited scope and short term approach is not consistent with the overall objective of the IASB to develop high quality principle-based standards. We generally support the idea of continuous improvement. However, the discussed topic is an extremely important one for many entities which have an urgent need of a sustainable and reliable solution. We think a short-term improvement should also be in accordance with basic long-term objectives (→ joint project) to improve the current status quo (which is definitely necessary) but also to blaze the trail for future adjustments.

As we proceed in the discussion of the ED, we will show that the amendment is rather a clarification of a general rule as stated in IAS 32 and therefore should be issued as an interpretation. Also, the proposed amendments seem to be too detailed to be included in a standard that should establish a financial reporting principle, rather than a set of rules.

If you would like further clarification of the issues set out in this letter, please do not hesitate to contact us.

Yours sincerely



Adolf Coenenberg



Simon Berger



Andreas Joest

## Responses to Questions in the Exposure Draft

### Question 1 – Financial instruments puttable at fair value

*The Exposure Draft proposes that financial instruments puttable at fair value should be classified as equity, provided that specified criteria are met. Do you agree that it is appropriate to classify as equity financial instruments puttable at fair value? If so, do you agree that the specified criteria for equity classification are appropriate? If not, why? What changes do you propose, and why? If you disagree with equity classification of financial instruments puttable at fair value, why?*

We do agree that financial instruments puttable at fair value should be classified as equity, provided that certain criteria are met. The stated criteria are appropriate to justify a classification as equity. However, we think that the wording stated in the section (b) of the definition of financial instrument “it entitles the holder to require the entity to repurchase or redeem for the fair value of a pro rata share of the net assets of the entity” should be replaced with “[...] for the maximum of the fair value [...]”. This is to include all contractual conditions favourable for the company, regarding the repurchase or redemption of the share of net assets. Taking business practice into account, there is no sustainable rationale given in the ED to justify this narrow requirement. Contrary to the current approach we would recommend to take into account that individually contracted settlements for less than the fair value (e. g. book value) clearly constitute an exchange of cash or financial asset under favourable conditions for the entity. Consequently, we consider it to be crucial to require companies to also classify financial instruments puttable at less than fair value as equity.

Analyzing the ability of the amended standards to make financial statements more comparable and provide better information, we object another definition that we consider to be limited. Our understanding is that there are only puttable instruments classified as equity if there are no other instruments in the same most subordinated class. By imposing this restriction, we believe that a company that offers puttable instruments as well as equity instruments without a put feature, for company specific or legal reasons, will have less equity on their balance sheet compared to an entity solely offering puttable financial instruments. Although the first entity would have a more solid equity basis, according to the current understanding of IAS 32, it would appear to be more leveraged. This would not result in a true and fair view on the entity’s financial status. In addition, the regulation could actually influence the decision towards just issuing puttable financial instruments, which would not be the desired result of the amendment.

Although we do support the IASB’s effort to clarify the understanding of equity according to the IFRS, we do not believe the actual standard (IAS 32) is the appropriate place for these definitions.

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As stated above, we believe this should be done in an interpretation with no alteration of the existing standard necessary. The interpretation would solely clarify and define a specific area, similar to what the Board did issuing IFRIC 2 *Member's shares in Co-operative Entities and Similar Instruments*. The rationale for doing so is the following:

In our opinion, the definition of a puttable instrument as stated in the amendment does already comply with the general concept underlying the definition of equity and liabilities under the Framework of the IFRS. A financial instrument that entitles the holder to a pro rata share of the net assets of an entity is, by the definition of the framework, equity (F.49). As a result, such an instrument bears the same risks and rewards as an ordinary share. A feature that allows the holder to require the issuer to repurchase or redeem such an instrument at the fair value of the pro rata share of the net assets (or residual interest in the entity) does not change the risk and benefit structure. It is not an exchange of financial assets or financial liabilities in a potentially unfavourable condition, as the transaction takes place at fair value (as we propose, at a maximum of fair value). If the liabilities are not covered by the assets, the residual interest would be zero and no obligation for the issuer of the instrument would arise. The mere possibility the holder of such an instrument could require the issuer to repurchase or redeem such an instrument does not constitute a liability. Other than a regular put-option, the holder's intention is usually not to benefit from the opportunity to sell directly, respectively require repurchase or redemption, but more of a safety and flexibility feature. A feature for the financial instrument being puttable could be required by law, as it is for co-operative entities in Germany. While the holder of a regular put option is highly likely to exercise, resulting in an economical benefit (as this is basically the sole purpose of a put option), the holder of a puttable financial instrument is not. This holds true in particular if the repurchase price is contractually fixed at less than fair value (e. g. book value), as no economical gain would result. Thus, the prevailing characteristic of such an instrument is the long term equity investment in the respective entity.

The obligation to deliver cash is usually not payable immediately at the request of repurchase or redemption but allows the issuer a minimum termination period before the payment is due. Until the holder of the financial instrument actually requires the issuer to repurchase or redeem, such a financial instrument does not bear any feature of a financial liability. The Framework defines a liability as "[...] a present obligation of the entity arising from past events, the settlement of which is expected to result in an outflow from the entity of resources embodying economic benefits"

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(F.49). IAS 37 requires a liability to be more likely than not to be recognized in the financial statements. Since the put feature in a puttable financial instrument is not the prevailing characteristic, and the likelihood of the request for repurchase or redemption of material proportions of such puttable instruments is rather low, we believe that classifying these instruments as liabilities would be misleading, even under current IFRS. From the exercise of the redemption feature to the actual settlement in cash by the entity, the financial instrument is a financial liability. As a result, the substance of such a financial instrument constitutes equity until the repurchase or redemption is requested. Following this rationale and focussing on the economical substance of a financial instrument, a financial instrument puttable at (a maximum of) fair value is equity.

As mentioned before, the suggested amendments, including the changes we suggested should be incorporated in an interpretation, to eliminate confusion. Several benefits could be achieved by this approach. The key idea of principle based financial reporting standards would be maintained without giving up the quality of information reported. In addition, it would facilitate the application in multiple legal environments, thus being internationally enforceable. The definition and constitution of equity is influenced by different legal environments in different countries. What actually matters for the investor, is the economical substance. In the current discussion, the differentiation between equity and liabilities focuses primarily on the interpretation of the wording in the IFRS, not the economical substance. The suggested argumentation and solutions should help to overcome this problem.

## **Question 2 – Obligations to deliver to another entity a pro rata share of the net assets of the entity upon its liquidation**

*The Exposure Draft proposes that an instrument that imposes on the entity an obligation to deliver to another entity a pro rata share of the net assets of the entity upon its liquidation should be classified as equity, provided that specified criteria are met (eg ordinary shares issued by a limited life entity). Do you agree that it is appropriate to classify as equity these types of instruments? If so, do you agree that the specified criteria for equity classification are appropriate? If not, why? What changes do you propose, and why? If you disagree with equity classification for these types of instruments, why?*

We do agree on classifying obligations to deliver to another entity a pro rata share of the net assets of the entity upon its liquidation as equity. However, we again think that such a clarification should be done in an interpretation.

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Substantially and economically, the obligation to deliver a pro rata share of a limited life entity upon its (predetermined) liquidation does not differ from the entity's obligation to do so in case of the liquidation of an entity that was not initially set up to have a limited life. Thus substance should again override legal form and be specified in an interpretation and not in the standard itself. This would result in the same benefits as stated for Question 1, the key idea of principle based financial reporting standards would be maintained without giving up the quality of the information reported and facilitate the application in multiple legal environments making it more internationally enforceable.

### **Question 3 – Disclosures:**

*The Exposure Draft proposes disclosures about financial instruments puttable at fair value classified as equity, including the fair values of these instruments, and the reclassification of financial instruments puttable at fair value and instruments that impose an obligation arising on liquidation between financial liabilities and equity.*

- (a) *Do you agree that it is appropriate to require additional information about financial instruments puttable at fair value classified as equity, including the fair values of these instruments? If so, do you agree that the fair value disclosures should be required at every reporting date? If not, why? What changes do you propose, and why?*
- (b) *Do you agree that it is appropriate to require disclosure of information about the reclassification of financial instruments puttable at fair value and instruments that impose an obligation arising on liquidation between financial liabilities and equity? If not, why? What changes do you propose, and why?*

As stated before, we believe reporting financial instruments puttable at fair value and obligations to deliver a pro rata share of the net assets upon liquidation should be classified as equity. Since both carry the distinctive feature to potentially become a liability (as stated above) and an obligation to deliver cash or other financial assets, these features, the pending conditions and the resulting risks should be disclosed. Also, the fair value of both should be disclosed on every balance sheet date.

To even enhance the understanding of the nature of the disclosures, the number of financial instruments puttable at fair value actually requested to be repurchased or redeemed, including their fair values should be disclosed for the reporting period. Additionally, the number of financial instruments puttable at fair value issued, including their fair values, should be disclosed for the reporting period. As a result, users of the financial statements could evaluate the stability of the entity's equity more accurately.

#### **Question 4 – Effective date and transition**

*The proposed changes would be required to be applied retrospectively, from a date to be determined by the Board after exposure (with one exception permitted relating to compound instruments). Earlier application would be encouraged. Are the transition provisions appropriate? If not, what do you propose, and why?*

Assuming substantial agreement about the contents of the amendments, only disagreeing on procedure and rationale, we would recommend applying the changes retrospectively. We do not have any further concerns about this aspect.